Advanced Contracts, Tendering and Public Procurement

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Part 01

Liquidated Damages in Government Contracts

This presentation will take you through the enforcement of liquidated damages and some of the landmark judgments precluded by the Supreme Court of India with special reference to government contracts.

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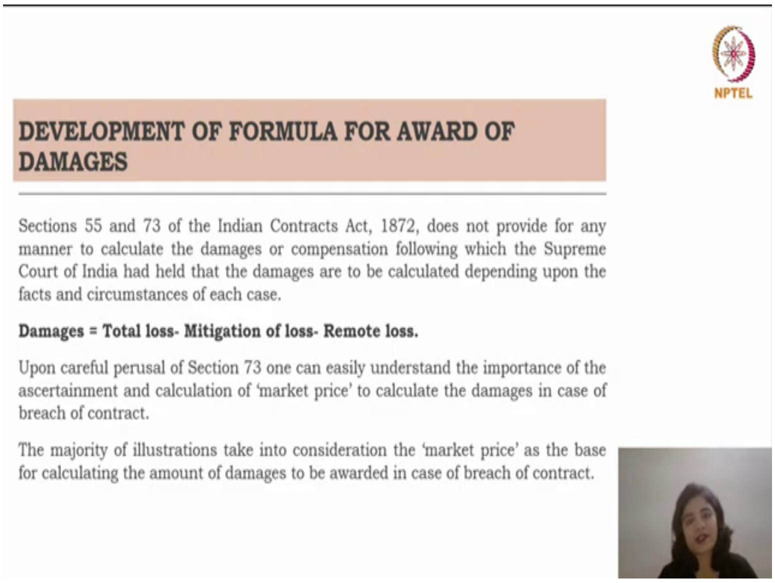

Before understanding the enforcement of liquidated damages, it is cardinal to understand the formula applied by courts for awarding damages. So here. the question is - is there any statutory general formula for calculating and awarding damages?

The answer to this question is an absolute no because even courts rely on the general principles set by case laws and precedents while awarding damages and it ultimately leads to a lengthy litigation process. So, this session explores the possibility and desirability of deriving a general formula for calculating and awarding damages.

Sections 73 to 75 of the Indian Contract Act 1872, deal with the law of damages, which is dealt with under Chapter 6. Specifically, section 73 and 74 of the Indian Contract Act deals with unliquidated and liquidated damages. What are liquidated damages? When the agreement between the parties stipulates the sum payable for non-performance of the contract, damages are said to be liquidated damages. And what are unliquidated damages?

Unliquidated damages are awarded by courts or arbitral tribunals on assessment of the loss or injury caused to the party who is suffering from the breach of contract. So, if you want to claim damages under section 73, that is, if you want to claim unliquidated damages there needs to be a contract, its breach and loss or damage following such breach, and is of such a nature that it is anticipated by the parties at the end of entering into the contract.

On the other hand, if you want to claim damages under section 74 that is if you want to claim liquidated damages, there needs to be a contract containing provisions for compensation or penalty in case of its breach by either of the parties to the contract. This is how you can claim damages under sections 73 and 74 of the Indian Contract Act 1872, but other essentials need to be followed for claiming damages.

The prima facie essential is there must be a breach of contract, and unless there is a breach of contract no damage can be awarded. The second essential is proof of loss for claiming liquidated damages. You must provide proof of loss, and you must provide evidence of loss in a court of law for claiming liquidated damages. An aggrieved party will not be awarded liquidated damages unless and until evidence has been submitted in a court of law.

The third most important requirement is causation, which means there must be a link between the loss suffered by the aggrieved party and the breach of contract. So, if there is a breach of contract there must be a loss, otherwise, damages will not be provided. The fourth essential is mitigation, which means every party who is breaching the contract should mitigate the loss suffered by the aggrieved party.

He must cover the loss that has been incurred by the aggrieved party in such a way that no contract has been performed had the contract not been performed, the aggrieved party would not have been in that situation. Therefore, these are the four essentials that need to be performed if you are claiming liquidated or unliquidated damages.

Once it has been ascertained as to what kind of damages are to be awarded, one must begin evaluating the same in monetary terms. Have you ever wondered why are we emphasizing coming up with a general formula for calculating and awarding damages? The primary idea behind coming up with a general formula to calculate and ascertain the damages is to ensure that the value expected by the plaintiff or the aggrieved party from the breach of contract is made good to them.

But you must always consider an important point that the damages awarded should not exceed the actual loss or injury suffered by the plaintiff or aggrieved party. Section 73 of the Indian Contract Act 1872 does not provide for any manner to calculate the damages or compensation following which the Supreme Court of India has laid down the damages are to be calculated based on facts and circumstances of the case.

However, if you look at section 73, there is a flavor of a general formula for awarding damages. You will find that essence upon considering section 73, damages would mean total loss minus mitigation of loss minus remote loss. Please consider section 73, and please consider the formula that is available on-screen and you will easily understand the importance of ascertainment of market price to calculate the damages in case of breach.

In the majority of illustrations, case laws, and precedents market price is considered as a base price for calculating the amount of damages to be awarded in case of breach of contract. If this is applied to a parallel study of Hadley versus Baxendale, a very important judgment, one can conclude that section 73 provides for recovery of damages, which are arising in the usual course of business resulting from the breach.

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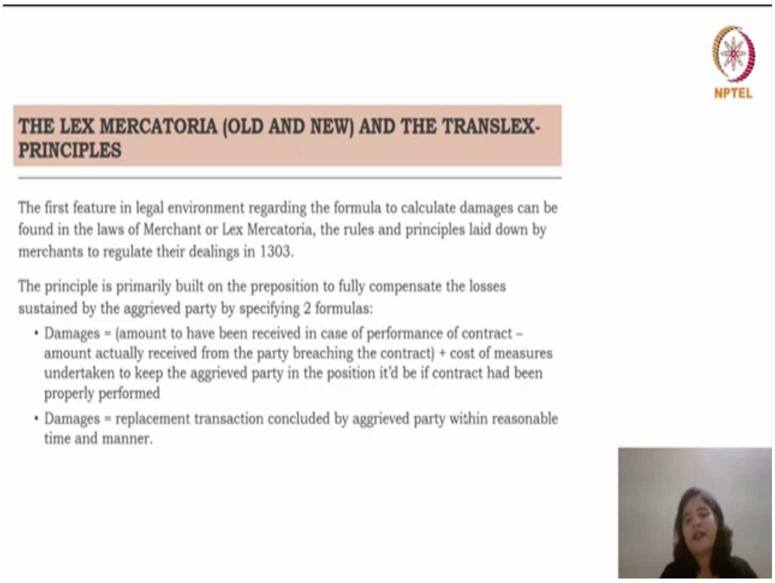

Have you ever wondered where the idea of garbing down a general formula for calculating and awarding damages comes from? The first feature in the legal environment regarding the formula to calculate and award damages can be found in the law of merchant also referred to as Lex Mercatoria. It is nothing but a commercial body of rules and principles laid down by the merchants to regulate their dealings back in 1303.

Principle 7.3.2 of Lex Mercatoria is on the calculation of damages and it states that the party who suffers a loss from the failure of the other party to deliver is entitled to damages and they are typically measured by the market value of the benefit of which the aggrieved party has been deprived through the breach of contract. It also says that the aggrieved party can calculate the loss based on the difference between the contract price and the price of a replacement transaction concluded within a reasonable time and in a reasonable manner.

The principle is primarily built on the preposition to fully compensate the aggrieved party and to compensate the losses which are sustained by the aggrieved party by specifying two important formulae. The first formula is; damages is equal to the amount to have been received in case of performance of contract minus the amount received from the party breaching the contract plus the cost of measures undertaken to keep the aggrieved party in a position it would be, had the contract been properly performed.

If you look at this formula carefully you will understand that Indian courts have religiously followed this formula; in a majority of case laws and precedents, this formula has been applied. The second important formula is damages are equal to the replacement transaction concluded by the aggrieved party within a reasonable time and manner. This is based upon Articles 75 and 76 of the United Nations Convention on Contracts for the International Sales of Goods; it is also referred to as CISG. When you look at these two formulas have you ever wondered whether it has been reinstated in any of the commercial codes or international conventions? The answer is yes. This formula has been reinstated in principles of European contract law, in unidroid principles of international commercial contracts 2016, and in the UK Sales of goods act chapter 4.

However, due to the development of national commercial codes, the principles of Lex Mercatoria or the law of merchants have declined to have an independent existence, but its principles were the basis of several national codes and still find relevance to date because many national courts have implemented the principles that were laid down in Lex Mercatoria.

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Before slurping up the discourse on liquidated damages, please note that it is extremely significant to understand the general formula for calculating and awarding damages before heading towards enforcement of liquidated damages. Moving towards infrastructure project contracts and building contracts, in most of the infrastructural projects, the Supreme Court has suggested the use of the Hudson formula to calculate and award damages.

We will be discussing the Hudson formula in detail as it is extremely important, but given the enormity and dynamic nature of infrastructural projects and the quantum of risk and stake involved in it, it is extremely important that the rights and obligations of the stakeholders involved need to be precisely laid out to promptly estimate and calculate the value of the project.

This is to facilitate the disputing parties to ascertain mathematically, the relevant amount of damages duly supported by the documents and evidence. In an infrastructural project contractual dispute, the claims for compensation apart from the value of variations based on rates and prices in the bill or scheduled rates and the contract can be referred to as head office overheads.

This is a very important term as certain formulae will be discussed based on this, and in every formula, this term has been used. This can further be divided into two categories; one is dedicated overheads and the other is unabsorbed overheads. When you talk about dedicated overheads, it is specific to the delay caused by an employer, so whenever any delay is caused by the employer it is known as dedicated overhead and when you talk about unabsorbed overhead it is usual contractor expenses like rents, salaries, etc.

These are the subheads of head office overheads. Now, the Supreme Court of India has noted the observations made in Hudson's Building and Engineering Contracts, that contracts which are about competitive tendering at the national level, and considering the evidence given on many such occasions suggest that the head office overheads and profit would come up to 3 to 7 percent of the total price of the cost that is added to the tender.

Therefore, courts on many occasions have allowed for compensation under the head of loss of profits in addition to and over and above the actual claims. So, this excerpt is taken from one of the landmark judgments which is Mcdermott International Inc versus Burn Standard Company Limited and others. In this case, Supreme Court had observed Hudson's building and engineering contracts and it had followed the formula of success.

Three formulas will be discussed. Here, the Supreme Court followed the formula of success that has evolved for the computation of a claim for increased overhead and loss of profit due to the prolongation of work. Quickly looking at the Hudson's formula; this formula was given by the United Kingdom and is acclaimed to assess delay damages in an infrastructural project.

The formula is O and P into contract sum into period of delay divided by 100 into contract period. Now, O and P refer to head office overheads and profit percentages in the tender or the contract. While applying this formula, head office overheads or you would say O and P, are considered as per the contractual agreement. They are usually taken into consideration as per the contractual agreement.

Although this formula has been used in several judgments it has been overlooked because it depends on the tender in dispute and because the calculation is dependent on the number which itself would contain an element of head office overheads and profits which would amount to double calculating; that is why this formula is usually not regarded and has been not completely but to some extent, has been overlooked because of this element of double counting or double calculating.

The complexity involved in understanding these formulae is understandable, especially because it has been applied in the United Kingdom, and then Indian courts have also followed it, hence it will take some time to understand these formulae and the elements that are involved in it.

But it is requested to look at the formula and then read the context, to cope with what has been laid down. So, we were talking about the Hudson formula and I would still say in my opinion this formula is used by many lawyers in a variety of arbitration proceedings, especially in contractual disputes regarding infrastructural projects and this Hudson formula has led to two other important formulae.

So let us discuss the second formula which is the Emden formula which is again very similar to the Hudson formula, as it resonates Hudson formula to quite an extent. This formula also originated in the United Kingdom and it calculates the head office overheads and profits that could have been achieved on a different job elsewhere and it applies to the whole reimbursable period of delay. So, this formula is quite like the Hudson formula.

It is O and P into contract sum into period of delay divided by 100 into contract period, so here again, O and P refer to heads office overheads and profit percentage. Although, the Hudson formula and Emden formula both resemble each other the major difference is that in the Hudson formula, the head office overheads and profit percentage are calculated based on the tender numbers.

Whatever numbers are available in the tender will be taken into consideration on those bases, head office overheads and percentages are calculated, whereas when you talk about the Emden formula the same is calculated based on actual numbers. The actual number is taken into consideration which makes this formula even more reliable and a lot of courts, not just in India, but even abroad have applied the Emden formula to calculate the damages.

Heading towards the last formula of this segment and indeed the most complicated one is Eichleay's formula which originated in the United States of America. While calculating damages, this formula does not consider the loss of opportunity. It is requested that the formula is taken down for your clarity and understanding.

We will be analyzing this formula, so if you look at the complex calculation under this formula it considers that if a significant proportion of final contractual valuation is made up of the value of variations, say more than 10 percent, 20 percent, or whatever is the value of variations, then an adjustment needs to be made to the formula to consider the fact that variations themselves would be contributing to the head office overheads and profits.

This formula is usually used when it is very difficult or almost impossible to give proof of loss of opportunity and the claim is based on the actual cost. If you look at the formula, it says that the total head office overhead during the contract period is first determined by comparing the value of work carried out in the contract period for the project along with the value of work carried out by the contractor.

Now that is allocated the same ratio and expressed as a lump sum to the particular contract. Here the amount of head office overhead that is allocated to the particular contract is then expressed as a weekly amount by dividing it by the contract period. The period of delay is then multiplied by the weekly amount to give the total sum that is claimed.

This formula is widely used even in the United States; Eichleay's formula is given a lot of significance by the federal court circuit. The federal court circuit of America believes that this formula is the best formula for compensating a contractor for overhead expenses. So whenever there is a matter of compensating overhead expenses Eichleay's formula is usually used especially in the United States of America.

We will not delve much into the technicalities of these three formulas, but this was just to give a brief overview of the fancy formulas that are laid out, especially for calculating the overhead expenses.

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Moving to the most interesting segment of this presentation is liquidated damages. We will study the origin, evolution, and present situation of liquidated damages. If you talk about origin, you will understand that liquidated damages can be extracted from common law, you will find elaborate discussions in the judgment of the House of Lords and one such judgment is Dunlop Pneumatic Tyre Company Limited versus New Garage Motor Company Limited.

In this judgment, it was held that the provision of liquidated damages will be enforceable only at the time of making the contract, where it is very difficult to determine the damages that would accrue if a contemplated breach occurred. So basically, it was held by the court that when there is difficulty in assessing the damages that are to be provided in the event of breach then liquidated damages will be provided.

Now keeping pace with the gradual commercial progression, the United Kingdom Supreme Court recognized the necessity of liquidated damages in one another judgment, which is called the Cavendish Judgment. The courts in this judgment had laid down the vintage law on liquidated damages that was crystallized in the Dunlop case; the court said that whatever test has been laid down in the Dunlop test is quite inadequate because of the complexities involved in commercial contracts.

When you look at modern commercial contracts there are a lot of complexities involved and the Dunlop test on liquidated damages is not at all adequate. The courts found that Dunlop tests can be used merely for assessing ordinary damages. Please note that ordinary damages are different from liquidated damages and that could no longer be considered sufficient to deal with liquidated damages clauses of a more complex variety found in contemporary standards.

I have already discussed liquidated damages under section 74 of the Indian Contract Act 1872. If you want to get clarity and understanding of liquidated damages it is better to look at Black's law dictionary definition, they have laid down in very simple language that an amount contractually stipulated as a reasonable estimation of actual damages to be covered by one party if the other party breaches is called liquidated damages.

If you look at this definition and try to understand it you will come down to the conclusion that liquidated damages are nothing but pre-estimated damage which the parties agree to while making a contract or entering the contract, as likely to arise at the time of a breach. So whenever there is a breach such kind of damages will be awarded, and there will be a proper liquidated damages clause in the contract.

They will jot down that clause and whenever there is a breach by one party the other party will be liable to pay damages as per the written clause. Whenever the courts are dealing with liquidated damages which are to be paid by one party to the contract to the other, they usually consider section 73 and section 74 together, because it gives clarity and understanding on providing damages. Why are damages awarded?

Damages are awarded to compensate the aggrieved party for whatever breach has occurred, but at the same time it is very important to understand that the aggrieved party should not be allowed to make unjust enrichment under the garb of claiming compensation out of the breach, if some party had faced some loss, then that amount should only be paid.

You cannot give more money. If you are giving more money than the loss it would amount to unjust enrichment, it should not happen that the party which breached should go into loss, and the other party has a lot of money because that would amount to unjust enrichment. This is a very important term and the Supreme Court had emphasized a lot on this term.

In the Indian Oil Corporation Limited case, the Supreme Court had come up with a policy called the 'no damages no loss' policy, which means whenever there is a breach of contract there must be some sort of loss. If there is no loss, no damages will be awarded to the aggrieved party or the plaintiff. This is a primary rule and I think also in my first slide while I was discussing essentials to claim damages, I had clearly said the prima facie pointers there has to be a breach of contract and when there is a breach of contract there must be a loss suffered by the aggrieved party. So, this is the requirement, a loss is essential and it is mandatory.

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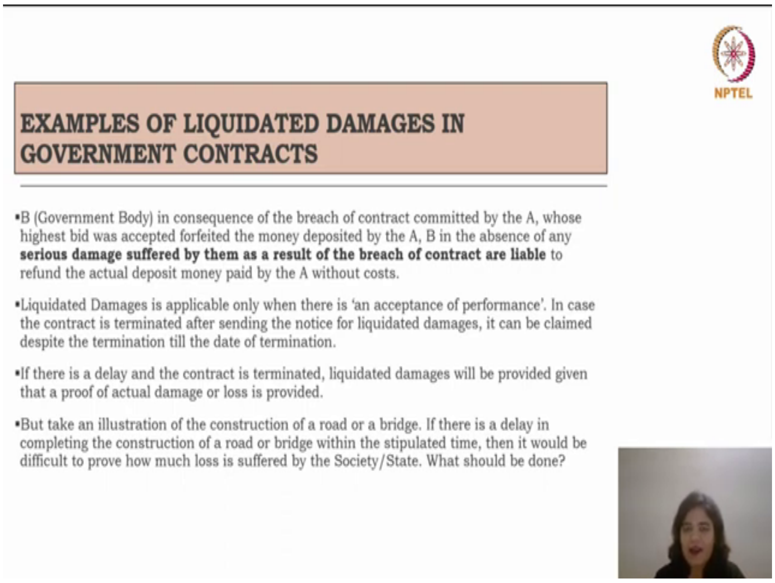

Now that we have understood that actual loss or damage is a prerequisite or sine qua non for awarding liquidated damages, let us head towards understanding some of the examples of liquidated damages. I want to clarify that damage and damages are different, damage is the injury, and is the loss incurred by the aggrieved party. So whenever there is any sort of loss that is damage; damages are compensation, an award that has been provided to the aggrieved party.

The letter s makes a lot of difference so please do not confuse damage with damages. So, before we head towards understanding the examples let me ask you another question; are liquidated damages analogous to penalty clauses? For a layman, yes; penalty, damages, and compensation everything is the same, but from a legal perspective, being a lawyer, you should know the difference between every term, each, and every legal jargon that has been used.

So yes, there is a thin line of difference between liquidated damages and penalty clauses. Liquidated damages are a pre-assessed loss agreed to between the parties at the time of entering the contract or making a contract. It is something that the parties jot down and they presume that it is likely to arise at the time of breach.

On the other hand, when you talk about penalty clauses, it is the stipulation to award an imposition that is so unreasonable, which is so excessive, which is so disproportionate that no prudent person would consider it a reasonable assessment of damages arising out of the breach. So basically, we can say that liquidated damages represent a reasonable stipulation of likely losses, whereas a penalty is far from reasonable and is usually intended to secure the performance of the contract.

So intentionally, the amount will be so high that it will force the other party to not breach the contract, securing the performance of the contract is very important, and for that penalty clauses have been formulated. Intentionally, the amount is high so that the other party will not breach the contract, so that is the thin line of difference between liquidated damages and penalty clauses. So now my major question to you is when can liquidated damages be enforceable?

Liquidated damages can be applicable only and only when there is an acceptance of performance. I am sure by now you all might have understood acceptance, promise, and offer; so, when there is acceptance of performance there is going to be a legit contract between the two where they can jot down liquidated damages clause, and then proceed with the entire process, but what if the contract is terminated after sending the notice for liquidated damages, can they still be claimed?

The answer is yes, it can be claimed despite the termination but only till the date of termination. In certain situations, whenever there is a delay, the contract automatically gets terminated or it is terminated by the other party. So in such circumstances can the liquidated damages be provided? The answer is yes, liquidated damages can be provided given that the proof of loss or evidence of loss is presented in a court of law.

Now see this is the second essential while I was talking about essentials to claim damages the first one was a breach of contract and loss the second was proof of loss and there, I had mentioned that proof of loss or evidence of loss is extremely important when you are claiming liquidated damages. So even if there is a delay and the contract is terminated you can ask for liquidated damages, but for that, you will have to provide proof of loss.

Now the major question here is in construction projects, say if there is a project or contract for the construction of a road or a bridge and if there is a delay in completing the construction of a road or a bridge within a stipulated period of time, will it be possible to provide liquidated damages because in such situations it is very difficult to prove the actual damage or loss suffered by the party.

So what should be done in such circumstances, that is the prima facie question because courts have mandated that yes if there is no proof if there is no evidence, we will not provide liquidated damages but not provide evidence in case of construction projects is it reasonable, should courts provide damages in such situations we will discuss this in the further slides because there is a very interesting landmark judgment and that will give us a clear idea that what should be done in case of construction projects.